



## Coast Guard HR Flag Voice 151

### PLANNING FOR YOUR FUTURE -- THE TIME IS NOW (PART 2)

#### Steps to Developing Your Plan

Once your current house is in order you can develop your plan for the future. You will need to answer a few questions: **What** is your goal, **How** much time do you have, **How** much are you starting with, and **How** much do you need to save to reach your goal.

#### Setting a Specific Goal

**Setting your goal is the first step to developing a sound wealth accumulation plan.** Financial goals can include things such as retirement, purchase of a house, children's education, extended vacations, or any number of other life long goals. Most goals will differ in the needed amount and the time you need the money.

Write down all of your goals and list them in order of importance. As you develop a plan for each goal you may discover that you might not be able to reach all of the goals that you set. Some of your goals may need to be modified or eliminated all together in order to meet your higher priority goals.

#### Determine Time Horizon

**Once you have your goal set, the next step is to determine how long it will be before you need the money to make that goal a reality.** Setting your time horizon is a very important step in building your plan because this will help you to determine both the amount you need to save and the type of investment (and amount of risk) that is appropriate for your accumulation goal.

#### Assess Your Current Savings

**Next, determine how much money you already have saved up for that specific goal.** Having a lump sum of money invested now for the goal can provide you with flexibility in developing your plan. The more money you have invested now, the less you need to save later, or you can choose to place your savings into a lower risk investment, or you can reduce the number of years to save, or a combination of all the above. After determining which money goes toward which goal, make sure that you place that money into the appropriate investment vehicle that meets your investment time horizon and risk tolerance (more information on understanding risk follows).

#### Calculate Your Savings Plan

**You first need to calculate how much you need to have saved up by the time you need the funds.** That calculation can be easy for some goals (e.g. - \$20,000 down payment for a house) while others can be difficult to determine (e.g. college cost or retirement). The more variables that are involved in the calculation, the more help you are going to need in determining how much you will need in the future.

Retirement planning is a good example of how difficult it can be to calculate your savings plan. Many factors need to be considered, including: desired retirement income; income expected from other sources such as social security, military retirement pay, and company pension plans; your life expectancy; desired retirement age; interest rates before and after retirement; whether your investments are in taxable or tax-deferred accounts; and expected inflation rate.

The questions that need to be answered can be a little overwhelming, but don't get discouraged, you have many resources available that will help you answer all of the questions. Financial planning resources can include website calculators, financial planning software programs, investment magazines and books, and of course individual financial planners. These various resources will help you to make educated assumptions and many times will calculate your savings plan for you. But before using these various resources, you need to understand how the assumptions that you use will impact how you develop your investment plan(s).

## **Fundamentals of Building your Investment Plan**

The following will provide you with various information that will help you understand the various features of investing.

An investment program should be built like a pyramid, with a strong, low risk, broad base of savings and insurance, and then moving up to the higher risk and higher growth potential vehicles.

## **Understanding Risk and Return**

Every investor wants to gain the highest possible return, but that higher possible return comes with a string attached, higher risk. Risk can be defined as the level of uncertainty that an investment has in achieving its expected return. **The level of risk that you are willing to take should be based on your investment time horizon, the need for return, and your tolerance for risk.** The longer your investment time horizon, the more aggressive you can be by taking advantage of growth investments, which historically perform better over longer periods of time. The shorter your investment horizon, the less risk you may want to assume since you would have little time to recover from any significant downturns which may occur in higher risk investments.

**To help you understand a little more about risk and reward,** let's review the historic yearly and average returns along with the worst and best one year returns for various investments. A summary is provided below. Stocks, which have the highest average returns (about 17% during the 1990's vs. cash/savings account interest of 5% during the same time period), also have the greatest one year loss (almost 27% in 1974 vs. lowest gain of about 3% cash interest in 1993). If you have a long time horizon, are patient, and have a sound investment plan, the investments with higher risk have the

potential to provide the greatest returns over the long run.

Stocks: Average Annual Return 11.6%; worst year -26.5%; best year 37.4%

Bonds: Average Annual Return 7.3%; worst year -7.8%; best year 40.4%

Cash: Average Annual Return 6.0%; worst year 2.9%; best year 14.7%

**When looking at these values, you need to ask yourself, how much risk am I willing to take in achieving my goal?** This is a very important factor to consider before investing. Risk tolerance can be defined as your comfort level in assuming risk and your ability to maintain the discipline of sticking to your investment plan when your investments decline. Most investors who take on too much risk panic when confronted with losses that they are unprepared for and sell the investment(s) at the worst possible time. The goal of purchasing investments is to buy low and sell high, but people who panic usually buy high and sell low.

A simple formula can help you assess the possible average return and level of downside risk that your portfolio may have based on your mix of investments. The multiples provided in the annual return and downside risk formula were obtained from above.

A hypothetical portfolio with 75% stocks, 20% bonds, and 5% cash may, based on historical results, provide you with following long term results:

**Projected Return:**  $[75\% \times 11.6] + [20\% \times 7.3] + [5\% \times 6.0] = 10.4\%$

**Downside Risk:**  $[75\% \times -26.5] + [20\% \times -7.8] + [5\% \times 0] = -21.4\%$

In other words, with the above mix of assets in your portfolio you have a potential long term return of 10.4% with the possibility of having a loss of 21.4% in any one year. If the return and risk level do not meet your needs, readjust your portfolio until you get the mix that is right for you.

**After deciding your general allocation, as shown above, between investment classes you must research various individual investments, examine their potential returns with their level of risk, and decide on whether those investments should be placed in your portfolio.** On average, if you find an investment that has high risks but low potential for returns, you should not purchase that investment. In the midst of a strong bull stock market, as in the late 90's, it is easy to forget about what risks are being taken to get the returns that go along with those high returns. But don't forget the market can, and will go down (as we've seen most recently).

Next: Fundamentals of building your investment plan (cont.)

Regards, FL Ames

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